Corporate Governance Monitor

Fall 2021

In the current edition of Corporate Governance monitor, Ferguson Partners shares recently published industry perspectives on current and critical Board-related issues.

Is Pay for Performance Broken?

Investors voted down a multimillion-dollar compensation deal for XPO Logistics CEO Bradley Jacobs this month amid a larger debate about how to better align remuneration for business leaders with their performance.

The International Brotherhood of Teamsters on May 11 led 54.5% of the Connecticut-based company's investors to oppose the board's plan to pay Jacobs a cash-based, long-term incentive award estimated at up to $80 million. The plan has an accelerated payout schedule that could allow Jacobs to receive half the award in one and a half years' time. The board also revised Jacobs' bonus plan midyear, allowing him to reap an additional $3.3 million. Overall, Jacobs is set to earn nearly $22 million, in total direct compensation for last year, up from $7.8 million in 2019, according to XPO's Securities and Exchange Commission filing.

The Teamsters union, whose associated pension and benefit funds have an estimated $100 billion invested in capital markets and are shareholders in XPO, won the advisory vote to defeat the pay package. But it lost the bid to oust key board members on the compensation committee and a proposal requiring the chairman to be an independent director, a role that Jacobs currently occupies. The proxy advisory firms Glass Lewis and Institutional Shareholder Services issued recommendations supporting the Teamsters' opposition to XPO's executive pay package.

The Teamsters and groups such as CtW Investment Group, which represents union pension plans, are part of a backlash against boards' maintaining or increasing CEO pay while softening executive performance targets, amid a health crisis that has hurt company profits and the global economy.

Boards should be especially careful and transparent about the reasoning behind changes made to executive compensation packages as they are likely to draw increased scrutiny during the Covid-19 pandemic, says Derek Butcher, a senior ESG analyst at RBC Global Asset Management.

> *"We recommend that compensation committees provide some robust disclosure on the adjustments that were made in light of Covid-19, so that investors can make an informed decision on voting on say on pay," says Butcher. "We are looking to ensure compensation plans are structured in a way that aligns the interests of management with shareholders and contributes to creating long-term sustainable value."*

The problem, some shareholder representatives say, is that current pay packages do not properly incentivize CEO performance beyond driving short-term company stock growth, says Simiso Nzima, investment director and head of corporate governance at The California Public Employees' Retirement System.

> *"We see the talent in the pay numbers. We don't see the talent in the performance, and that's a huge problem," says Nzima.*

The organization, which is tasked with investing pensions' savings and had an estimated $440 billion worth of assets as of last December, voted against 51% of executive compensation packages at more than 2,600 companies last year in the U.S., due to poor pay-for-performance alignment. It voted against thousands of board members for failing to hold executives accountable for poor performance.

Calpers has developed its own metrics for analyzing long-term company performance across all industries based on a five-year window instead of the three-year horizon most businesses rely on. The organization has zeroed in on what it calls the bad practices that have led to ballooning executive pay not correlated to long-term value creation.

It says companies adopt inflated executive compensation packages by benchmarking themselves against a peer group of similar companies and then failing to also compare performance against the same peer group.

> *"If a company's historical performance is at the 25th percentile of peers, it seems unjustified to target pay at the 50th percentile of peers," notes Calpers in a recent guidance.*

A body of research going back two decades shows the link between CEO pay and performance may be tenuous. Academic studies looking at whether CEO pay is linked to a firm's long-term growth have found a weak connection on average and sometimes extreme examples where the highest-performing firms have some of the lowest-paid CEOs and the highest-paid CEOs have some of the lowest performance, according to Robert Wiseman, the senior associate dean at Broad College of Business at Michigan State University.

"I'm not addressing the market characteristics for hiring or keeping a CEO. That may be true. What I'm saying is that pay is disassociated with the firm's performance."

Equity — long touted as a way to incentivize executives to balance dependable growth with risk-taking, which is key to value creation — may lead to the CEO's being over-invested in their own company and becoming a bit more cautious.

The right way to structure pay packages may be to link pay to clear outcomes like the number of patents a technology firm files, for example, says Wiseman.

Ferguson Partners Survey: REIT NCG Chairs Share Top Priorities

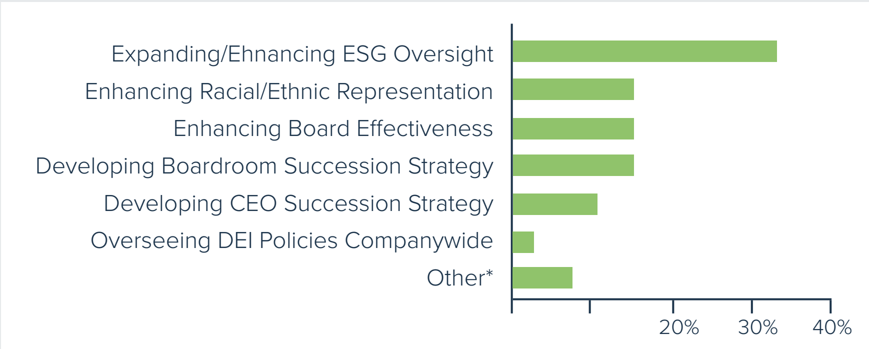
Recently, Ferguson Partners conducted its 2022 NCG Chairs Priorities Survey to understand key strategic issues top of mind for today's Nominating and Corporate Governance Chairs across the REIT industry. Survey findings revealed that priorities were largely aligned with those seen across the Fortune 500.

Below are highlights of emerging themes common to respondents.

- Expectedly, ESG oversight is the top priority as all public companies attempt to define investor expectations, prioritize what is most important, and determine who within the organization (Board, executive leadership, etc.) is responsible for which areas.
- Enhancing ethnic diversity across the organization is an exceedingly high priority and must begin at the Board level (where over 70% of public companies have no ethnic diversity). Common thinking here is that ethnically diverse Directors will encourage the same in the C-suite, ultimately leading to a "trickle-down"

effect that fosters ethnic diversity across the organization. But what many public companies overlook is that retaining ethnically diverse employees is equal in importance to recruiting them, and that a supportive culture — including mentorship and career development opportunities — must be created.

- Board effectiveness proved a high priority, which makes good sense in a volatile economic environment fostered by the pandemic, pace of change, disintermediation, big data, and more. Given these factors, the Board's charge of opining upon the corporate strategy espoused by the leadership team, is even more critical. The same holds true for the Board's charter around human capital issues such as CEO succession, executive compensation, DE&I, and others. The Board must have Directors qualified to address these incredibly important issues via constructive Boardroom discussions.



- Surprisingly, responses revealed issues of Boardroom/CEO succession to be lesser-than-expected priorities for public company boards. This is surprising in that Board leadership must be qualified and developed as future Lead Independent Directors, a vitally important role as key partner to the CEO and one which provides leadership to the balance of the Directors. And CEO succession is not addressed critically enough by today's Boards. Internal candidates must be proactively assessed for their leadership and strategic skills and a development plan should be formulated and executed to prepare them to succeed the CEO. Too often Board members select whom they "like," only to find out too late that this candidate was indeed unqualified and must then be terminated, and that an outsider must be recruited – a very disruptive (and avoidable) set of circumstances.

Recruitment of Black Directors Rises Almost 200% at S&P 500 Companies

Large companies have elected a record number of new Black directors for board seats in a bit under one year, an unprecedented surge largely driven by social justice movements that spurred investors to call for more diverse candidates at the top levels of the business world.

The appointment of Black directors by S&P 500 companies surged by nearly 200% in the preceding 11-month period ending on May 19, according to research by ISS Corporate Solutions, a subsidiary of proxy advisory firm Institutional Shareholder Services.

Additionally, 148 S&P 500 companies appointed Black directors during the period, up from 52 companies in the same time frame the year prior.

At a time when corporate profits have been buffeted by the Covid-19 pandemic and global lockdowns, investors are pushing companies to appoint varied personnel due to a growing body of research showing that businesses with more diverse boards and workforces tend to financially outperform their peers.

"It's really pushing the dialogue from an investor perspective," says Marija Kramer, head of ISS Corporate Solutions. "We're seeing the pipeline of available [diverse] candidates really picking up significantly."

According to an analysis by ISS Corporate Solutions, 32% of newly selected directors were Black, and 52% were white for the 11-month period ending on May 19, compared with 11% and 74% appointed for the preceding comparable period ending in 2019, respectively.

Yet Kramer notes that diversity gains at corporations did not extend to the appointment of Asian and Latino board candidates. Those numbers remained flat at about 4%, during the time frame in which boards focused intently on seeking out Black board candidates.

"I was a bit surprised to see that in particular in two populations the Hispanic or Latin American and then also Indian, South Asian...those numbers have not moved," says Kramer. "While the justice [movement] in the [U.S.] has largely been focused on African Americans, I certainly would have thought...companies looking to diversify [would] look at the products and services that they're selling and represent their market base. I would have expected to see a bit more of an uptick there."

S&P 500 Companies' Appointments of New Board Members

Race/Ethnicity	July 1, 2018 - May 15, 2019	Percent	July 1, 2019 - May 15, 2020	Percent	July 1, 2020 - May 15, 2021	Percent
Asian (excludes Indian/ South Asian)	10	2%	19	4%	13	3%
Black/African American	55	12%	55	11%	165	32%
Caucasian/white	351	77%	361	74%	277	54%
Hispanic/Latin American	10	2%	24	5%	24	5%
Indian/South Asian	18	4%	18	4%	20	4%

Source: ISS Corporate Solutions

ISS sent a letter last year asking companies to share demographic data after hearing from various institutions that they want to consider information about a range of metrics, including pay equity and diversity, in their investment calculations. While companies were hesitant to share information out of concern for privacy laws, Kramer foresees a future where such disclosures could become the norm.

LGBTQ+ Representation in the Boardroom Is Critical for Every Successful Business

For years, companies have known that promoting LGBTQ+ inclusion is good for business. But recent changes in the legal and regulatory landscapes, paired with growing consumer demand, have transformed what was once merely a profit-booster to a business necessity.

Today, diversity among the people making corporate decisions unquestionably drives better outcomes, and LGBTQ+ representation in the "room where it happens" is a critical component to optimizing corporate success.

States Are Requiring Diversity in the Boardroom

A wave of state legislation has been enacted in recent years urging, and in some cases mandating, public companies to appoint diverse directors to their corporate boards. While this legislation primarily has focused on increasing female representation on corporate boards, the call for board diversity has expanded — and will no doubt continue to expand — to members of the LGBTQ+ community.

As it often does, California has emerged as the leader in these efforts. In 2018, the nation's largest state by population adopted legislation requiring its companies to appoint at least one female director to their corporate boards. Last September, it pushed the envelope further, by enacting Assembly Bill 979 ("AB-979"). That law requires publicly held companies with "principal executive offices" in California to further diversify their boards by the end of this year by including at least one director from an underrepresented community. AB-979 expressly lists individuals who identify as gay, lesbian, bisexual, or transgender as members of an underrepresented community, along with members of various racial and ethnic groups. And this isn't all bark and no bite — failure to comply could result in significant monetary penalties.

Other states are likely to follow suit. To date, numerous states have already adopted legislation mandating or encouraging gender diversity. Washington state, for example, requires that women hold at least 25% of public company board seats, and Hawaii, Massachusetts, Michigan, Ohio, and New Jersey are considering similar legislation. Similarly, Colorado and Pennsylvania have each passed legislation encouraging publicly held companies to increase the number of women appointed to corporate boards.

As the rationales for diversifying boards with racial and sexual minorities dovetail with those for gender diversification, it is only a matter of time before other states follow California's lead.

Regulatory Bodies Are Considering Rules Mandating LGBTQ+ Inclusion in the Boardroom

State legislatures are not the only ones taking up the mantle of board diversification. Regulators are also well attuned to this issue, and in recent years have considered rules to promote this objective.

One of the prime examples of this occurred at the end of 2020, when Nasdaq filed a proposed rule change with the U.S. Securities & Exchange Commission that would require public companies to increase corporate board diversity by appointing at least one woman and one member of an underrepresented minority. The proposed Nasdaq rule, like the California statute, considers the LGBTQ+ community to be an underrepresented group. Nasdaq's proposal also asked the SEC to require companies to publish diversity data in public disclosures and publicly disclose the reasons for any failures to meet the board diversification requirements or risk being kicked off the exchange.

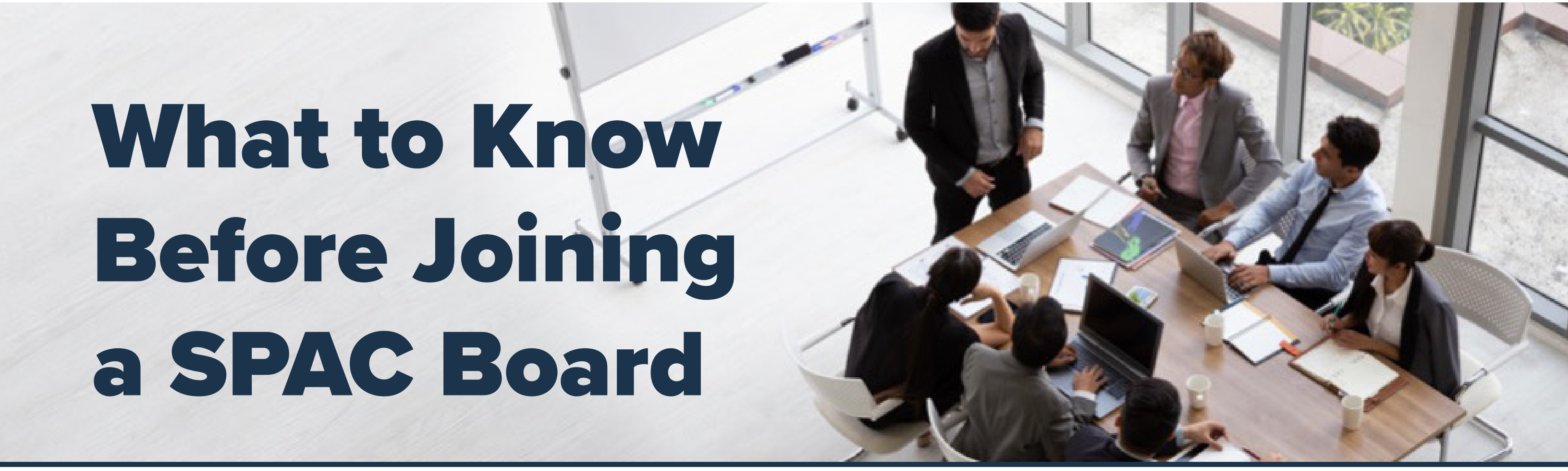
Consumers Are Demanding LGBTQ+ Inclusion in the Boardroom

Over the past decade, many companies have outwardly expressed their acceptance and support of LGBTQ+ individuals both because it is the "right" thing to do and to tap into the immense buying power of the LGBTQ+ community. The NFL, for example, launched a series of initiatives at the end of last year promoting LGBTQ+ History month which included airing LGBTQ+ content on the NFL network and creating a PSA of NFL players voicing support for the LGBTQ+ community.

While positive — for example, running advertisements that include LGBTQ+ couples or participating in LGBTQ+ events — these types of initiatives are no longer enough to earn the loyalty of LGBTQ+ consumers and those who care about LGBTQ+ equality.

These groups are demanding that members of the LGBTQ+ community have a seat at the corporate table, where power truly resides and change can really happen.

What to Know Before Joining a SPAC Board



Directors can receive a hefty windfall for taking a seat on a Special-Purpose Acquisition Company (SPAC) board, and such appointments present new and interesting challenges for a seasoned director. However, sources say it's important to weigh the attendant risks before getting involved.

In the past year, for example, litigation involving SPAC directors has soared, and SEC scrutiny of the transactions has also ramped up along with the popularity of the vehicles. Proxy advisory Institutional Shareholder Services has also noted that given their time demands, it will count SPAC board seats when weighing whether a director should be considered overboarded.

Meanwhile, each SPAC is a unique business and directors need to kick the tires before signing on. SPACs are essentially shell companies created with the sole purpose of raising capital to acquire or combine with private companies, including start-ups, to eventually take public while bypassing the traditional IPO process.

Joining a SPAC board can diversify directors' experience as company board members, Grossman writes. Plus, following the business combination, directors may have an opportunity to transition to board roles at the newly public company, he says.

There are also financial incentives. Recent SPAC IPOs paid directors a median of $215,000 in annual board service cash and equity, which doesn't include initial equity grants, which can run up to $400,000, as reported in Farient Advisors' recent column in Agenda.

Litigation and Other Risks

Meanwhile, there are risks for board members. For example, there have been numerous instances of litigation surrounding SPACs and companies made public through SPACs, sources say.

For example, PureCycle Technologies completed its merger with Roth CH Acquisition I Co., a SPAC, in March. Investors filed a securities class action suit against PureCycle earlier this month alleging that the company made false and misleading statements and failed to disclose numerous issues, including that the management team at Roth had previously brought six other businesses public "only to have each implode thereafter," according to the plaintiff's complaint.

Directors should ascertain that SPACs have adequate D&O insurance to cover board members, sources say. It's important that directors inquire how much D&O coverage the SPAC has, given how costly this insurance has become and "whether the coverage in place is adequate in the eyes of a potential board member," writes Karim Anani, EY Americas' financial accounting advisory services transactions and SPAC co-leader, in an email.

Joining a SPAC board can also be time-consuming, sources say. Indeed, ISS considers SPAC board seats in its overboarding voting guidelines. ISS considers non-executive directors overboarded if they hold more than five public company board seats and considers CEO directors overboarded if they hold more than two outside board seats.

It's also important for SPAC directors to "be on the lookout" for potential conflicts of interest, including if a director has a preexisting relationship with a potential target, writes Iliana Ongun, a partner with law firm Milbank, in an email, without referring to any specific SPAC or company. "Any such potential conflicts should be raised to the board as soon as they are identified."

SEC staff is also closely scrutinizing SPACs. For example, acting director of the corporation finance division John Coates said in a speech last month that the staff is "seeking clearer disclosure" by SPACs and their private targets and looking closely at other potential issues for investors, including forward-looking statements and liability protections.

Due Diligence

Similarly, robust due diligence of targets is important, sources say. Since target companies are usually less mature, they may not have the same rigor as an established company in terms of financial reporting, internal controls or compliance infrastructure, according to Jon Foster, managing director of Current Capital Partners and a board member at Berry Global, Lear Corp. and Masonite International.

Additionally, Foster says it's important to note that the financial projections made in a de-SPAC transaction are "somewhat speculative." Especially for start-ups, projected revenue may not paint an accurate picture.

Other potential areas of improvement for SPAC targets before they become public companies include cybersecurity and vendor management programs. Likewise, the target management team may benefit from communications training, "as they will soon find themselves representing the company in front of a larger audience with higher stakes," writes Ongun.

Portions of the included articles, originally published in Agenda, have been edited for length and clarity. Authors include Amanda Gerut, Neanda Salvaterra, David S. Flugman, Megan Larkin, Faith Gay and Lindsay Frost.